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The supply of investible funds may be said to flow from three sources — from amortization quotas, from new savings out of current income and from "inflation" in the broad sense.

Gottfried Haberler, *Prosperity and Depression*, 1937

AMERICA'S CRISIS

In congressional testimonies and public speeches, Fed Chairman Alan Greenspan has repeatedly emphasized that despite suspicions, it is very difficult to definitely identify a bubble until after the fact — that is, when its bursting confirms its existence. In the same vein, he has always discarded the notion that a well-timed incremental tightening could have prevented the 1990s bubble.

In a testimony in mid-1999, he stressed, instead, the need to focus on policies *"to mitigate the fallout when it occurs and, hopefully, ease the transition to the next expansion."* Considering that asset bubbles accrue from excessive monetary looseness, this preference of treating its aftermath instead implicitly boils down to doing so with still more monetary looseness.

That is just what Mr. Greenspan has been doing for more than two full years, but unfortunately with minimal economic effect. In the fourth quarter of last year, nonfinancial credit growth went exponential to $1,563.2 billion, associated with additional financial credit growth of $1,097.7 billion, both numbers at annual rate. At the same time, the federal budget deficit was up $198.5 billion, also annualized.

And what was the effect of this most prodigious input of monetary and fiscal stimulus on GDP? It grew in nominal terms by $80 billion and in real terms by $33.6 billion. Annualizing the two figures, it was $320 billion and $134.4 billion respectively. Such a miserable relationship between most lavish measures of economic stimulation and their minimal economic effects is definitely unprecedented in history, suggesting the existence of some big growth-impairing problems in the U.S. economy.

As a matter of fact, we never expected anything else. The U.S. economy's protracted sluggishness has its cause in a variety of growth-impairing imbalances and dislocations in the economy and the financial system that have accrued from the stupendous credit excesses of the past. Considering that they all accrued from excessive monetary looseness during the boom, it seems rather stretched to assume that still looser money is the appropriate remedy.

In the consensus view, the Fed's dramatic easing was successful in preventing a longer and deeper recession. It is the great story in the markets that U.S. economic growth keeps outpacing that of the euro zone, where the central bank seems to be asleep at the wheel.

But the fact is, during the nine quarters of worldwide slow economic growth during 2001–02 and the first quarter of 2003, U.S. real GDP growth effectively averaged 1.5% at annual rate, while that of the euro zone averaged "only" 1.12%.

First of all, we would say that this petty difference in the growth rates between the two areas hardly justifies the ballyhoo that is being made in the media and the markets about America's superior growth performance. But second, we have to point out that this difference in the growth rates is more than accounted for by the difference between America and the euro zone in calculating their inflation rates. Due to heavy discounting of quality improvements, America's inflation rates have a distinctly lower bias in comparison to those of the euro zone. In 2002, the euro zone's GDP deflator was 2.3%, as against an American GDP deflator of 1.6%.

THE CRUCIAL U.S. IMBALANCE

America's crucial and by far single biggest imbalance is definitely the one between minimal domestic savings and virtually limitless credit growth. It used to be a truism among economists that in a healthy and well-balanced economy, the supply of sound, noninflationary credit is strictly limited to the supply of available domestic savings out of current income.

For the old economists, saving is not only desirable for investment, but indispensable. As people consume less than their current income, they release productive resources for the expansion and improvement of the economy's stock of plant and equipment. These physical facts are basic. In other words, saving is more than money. Without such savings the economy's capital stock will stagnate or shrink. It is the function of credit to make those resources, released by saving out of current income, available to the borrowers.

In 2002, total credit expanded in the United States by $2,286 billion, of which $1,363.7 billion was nonfinancial, and $922.4 billion financial credit. This compared with net national savings of $286.7 billion.

In essence, it is the task of central banks to keep new savings and new credit in equilibrium through their interest policy. Implicitly, any lending in excess of current savings essentially causes imbalances and distortions in the economy or in the financial system. It strikes us that Mr. Greenspan and American policymakers do not care in the least about saving.

In the United States, net national saving — combining the savings of consumers, business and government — has always been among the lowest in industrial countries. But lately, it went increasingly out of existence. With the soaring federal budget deficit, it is now on its way into negative territory. Yet next to high-savings Japan and Switzerland, America now has the lowest interest rates in the world.

ANOTHER GIGANTIC BUBBLE

How is that possible? In short, through the heavily leveraged carry trade, borrowing at the low short-term rates and investing into much higher-yielding bonds. It was a regular cyclical play that positively helped to lower longer-term interest rates in times of slow economic growth. As soon as the economy recovered and a rate hike by the central bank came into sight, the speculators unwound their positions, sometimes with temporary setbacks for long-term rates.

But in the last few years America has broken completely new ground in this respect. In the virtual absence of new net savings, the leveraged carry trade is no longer marginal in the markets. It has become the market.

Looking at the steep decline of U.S. long-term interest rates, it has been a smashing success. In recent weeks, in particular, Treasury yields dived close to postwar lows. It was apparently inspired by one sentence in Mr. Greenspan's recent congressional testimony: *"Indeed, we have reached a point at which, in the judgment of the Federal Open Market Committee, the probability of an unwelcome substantial fall in inflation over the next few quarters, though minor, exceeds that of a pickup in inflation."*

What was so inspiring in this sentence? Expectations of an imminent U.S. recovery had been suggesting that the Fed was finished with its rate cuts and that the next move would be upward. But by remarking that he worried more about an unwelcome fall in inflation than a pickup, Mr. Greenspan suppressed any such fears, evoking instead the possibility of another cut. Speculators eagerly seized the opportunity to pile up on their carry trade.

Being completely driven by borrowed money, America's booming bond market is in reality just another gigantic bubble, but one that is highly vulnerable to the slightest rate hike, or even only the threat of it. When the Fed moved up its federal funds rate by just one quarter of one percentage point on Feb. 4, 1994, it shattered the bond market by triggering massive forced selling on the part of highly-leveraged speculators. In the fall of the year, the 30-year Treasury bond yielded more than 8% as against less than 6% a year earlier.

Since then, the carry trade bubble has multiplied, essentially implying a far greater shock to the bond market from any rate hike than in 1994. But there is still another important difference between then and today. Then, the bursting

carry trade bubble hit a strong and sharply recovering economy that easily absorbed the sudden surge in long-term rates.

This time, manifestly, a far greater shock to the credit markets would hit a far more fragile economy. For us, there can be no doubt that it would nip any possible moderate rebound in the bud.

MASSIVE STIMULUS WASTED

It is the consensus view in America that prolonged recessions and depressions, as in the 1930s in America and as presently in Japan, have their key cause in the failure of the central banks to cut their interest rates rapidly enough. Plainly, the Fed is determined to avoid that mistake.

While Mr. Greenspan and many others claim full success to this policy, we see a shocking and frightening discrepancy between the massive overall stimulus and its extremely poor effects on economic activity. Moreover the latest data point distinctly towards double dip, not recovery.

But why? In short, it has its reason in the persistence of the very same aftereffects of the bubble that caused the economy's downturn in the first place. While the Fed's aggressive easing may well have prevented an immediately deeper and longer recession, it has also prevented any correction in the bubble's legacy of growth-impairing imbalances and dislocations.

Between 2001 and 2002, the Federal Reserve slashed its overnight rate 12 times from 6.5% to 1.25%. At the same time, the Bush tax cuts and the economy's weakness have turned a federal budget surplus of $295.9 billion in 2000 into a $257.5 billion deficit in 2002, with the prospect of a further rise to $400–$500 billion in the current year. Together, this represents the most prodigious economic stimulus in history.

Although personal incomes rose in 2001–02 by $671.2 billion, tax payments fell by $180 billion. Plunging mortgage rates and rising house values enabled millions of homeowners to extract approximately $1 trillion from their home equity during those two years. Measured by this number, it was the most potent interest cut under the sun. Yet consumer spending slowed to $715.3 billion overall in 2001–02, from $818.9 billion in the two prior years, 1999–2000. With all the mortgage refinancing, it was down to an annual rate of $309.6 billion in the first quarter of 2003.

There is a widely held view in the markets that the U.S. economy, though performing much worse than expected, is nevertheless outperforming all other countries. Measured in aggregate real GDP, that is true. But the superior quantity of growth has been concealing a most miserable quality in terms of its composition.

Last year, U.S. real GDP grew by 2.4%. Of this total, personal consumption accounted for 2.12 percentage points, or 88.3% of the growth. Further substantial contributions came from government spending (0.81 percentage points, or 33.7%) and from higher inventories (0.60 percentage points, or 25%). Against these three major additions stood two major subtractions: nonresidential fixed investment (-0.68 percentage points, or 28.3%) and net exports (-0.61 percentage points, or 25.4%).

Basically, recessions are the phase in the business cycle in which consumers and businesses, forced partly by tight money and credit, restrain and correct their boom-related borrowing and spending excesses and return to a desired and sustainable consumption-savings-investment pattern. Inevitably, such retrenchment curtails demand and slows the economy. The regular, striking features of the adjustment process, paving the way for the next recovery, are higher rates of personal and business saving.

The U.S. economy is clearly in an adjustment crisis, but its extremely ill-structured growth pattern of 2002 reveals a total lack of the adjustments necessary for more balanced growth. Rather, existing maladjustments keep worsening.

UNPRECEDENTED IMBALANCES

During the whole postwar period, developing booms were regularly stopped at a rather early stage as central banks, responding to rising inflation rates, put the brake on the credit supply. The main imbalance used to be in inventories associated with moderate excesses in business fixed investment, commercial and residential

building. All these excesses used to be unwound, on average, within a year. As central banks eased their credit reins in response to falling inflation rates, the economies promptly rebounded.

This time, the maladjustments depressing U.S. economic growth are, manifestly, far more numerous and radically different from this former garden-variety recession. The legacy of the U.S. bubble economy are an unprecedented profit and capital spending crisis; badly ravaged balanced sheets; a yawning current-account deficit; devastated national savings; and a secular bear market in stocks destroying consumer wealth and preventing equity issuance by corporations.

It should also be clear what caused all these growth-impairing ailments: unprecedented credit excesses in relation to collapsing savings. But in none of his utterances has Mr. Greenspan ever indicated any deep understanding of the situation. Rather, in his most recent congressional testimony, he praised the U.S. economy's resilience to serious blows: *"a significant decline in stock prices, a substantial fall in capital spending, the terrorist attacks of September 11, confidence-debilitating revelations of corporate malfeasance, and wars in Afghanistan and Iraq."*

A bubble economy is, by definition, an economy in which soaring asset prices fuel a borrowing and spending binge, boosting domestic demand and economic growth. But the next key question is the specific demand component that the asset bubble drives to excess. By creating wealth effects for investors, it may overstimulate consumption; by slashing capital costs, it may overstimulate capital investment.

Both patterns are possible. Japan's land and stock price bubble of the late 1980s went overwhelmingly into a roaring investment boom in manufacturing plant and commercial building. Together, the two investment components increased as a share of GDP by 10 percentage points. Soaring equity prices induced and enabled large firms to strengthen their balance sheets by heavy issuance of stocks and equity-linked bonds at very low interest rates. Buyers accepted near-zero rates hoping to convert the bonds later into equities at favorable prices. Although consumption also rose, it fell as a share of GDP.

What, then, did America's great asset bubble of the late 1990s mainly propel? Was it overinvestment, as in Japan, or was it overconsumption? And next question: Is this spending excess being corrected?

THE KEY PROBLEM: OVERCONSUMPTION

In the consensus view, America's key problem today is that U.S. corporations have overinvested in the recent boom years, saddling themselves with a huge "capacity overhang" that is now inhibiting new investment. But in this view the salutary correction of this overhang is in this view well on its way, as businesses have savagely curtailed their investment spending.

> Speaking about the outlook for business investment (April 24, 2003), Fed governor Ben S. Bernanke stated:
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> *The weakness of business fixed investment during the past three years contrasts sharply with the investment boom that was one of the most striking features of the U.S. economy in the 1990s, particularly during the second half of the decade. Growth in real investment averaged close to 10% per year between 1995 and early 2000. For comparison, during the strong 1983–87 recovery, real investment grew less than 6% per year. The rapid pace of business investment in the nineties was central to the unusually high rates of economic growth, low rates of unemployment, and rapid productivity growth that we observed during that period.*

It seems to have become conventional wisdom in the United States that the main problem is a capital overhang inhibiting new capital investment. In real terms, spending on equipment and software in the second half of the 1990s accounted for 30% of GDP growth, more than double its contribution in the prior decade.

But as we have explained many times, this measurement is badly flawed. First of all, the spending figure in

real terms has been grossly inflated by the hedonic price adjustments for high tech. And second, a drastic shift in the investment pattern towards very short-lived high tech implied a very high rate of obsolescence, leaving less and less of the gross investment for additions into the capital stock. Measured by nominal net investment and the growth rate of the capital stock, the investment ratio was rather at the bottom of its historical range.

Rampant hype about profit and productivity miracles from heavy investment in the new information technology was crucial in rationalizing and driving the greatest stock market bubble in history, but the economic reality in America was a wealth euphoria among the American public that propelled the most reckless consumer borrowing and spending binge of all times, essentially at the expense of capital investment.

In particular two figures strikingly illustrate the tremendous imbalance that developed in the United States during the boom years between galloping domestic demand and creeping domestic supply — real growth of the net stock of manufacturing fixed assets averaged 2% per year, while real demand growth averaged 5% per year.

Japan's investment boom during the bubble years, as earlier mentioned, showed conspicuously in a soaring share of investment in GDP growth. In the United States, the exact opposite shift in the composition of GDP has taken place. Since 1997, private consumption has steadily been accounting for almost 90% of GDP growth, compared with 60–70% in the past. The other striking evidence of a consumption excess is, of course, in the collapse of personal saving during these years.

THE M&A FAIRY TALE

During the late 1990s American businesses, too, stampeded into debt as never before, but what they financed with the borrowed money was least of all new capital investment. In frenetic pursuit of the quickest possible rise of profits and shareholder value, they chased each other's equity at prices vastly in excess of current market prices.

Rather than generating income growth through producing new plant and equipment, America's corporate managers virtually purchased growth and profits in the quick way through mergers and acquisitions, including large-scale purchases of their own stock, raising profits per share by shrinking their number.

Unquestionably, the developing massive deal-making played a key role in sending U.S. stock prices skyward. In so far, they created sharply higher value for shareholders. Yet the truly crucial question is essentially whether or not this massive corporate deal-making is beneficial for the economy as a whole. Only then can it be beneficial for corporations in the long run.

From the macro perspective, it was never in doubt to us that the M&A frenzy was incipiently destructive for the U.S. economy's growth and for overall corporate profitability, even in the short run. For the single corporation mergers and acquisitions are clearly the fastest way to expand, but such shuffling of existing assets lacks all the macroeconomic income, demand and supply effects that come with new capital investment and that make the essence of healthy economic growth. It was not by accident that the beginning of America's profit malaise coincided with the height of the merger and acquisition frenzy in 1998–2000.

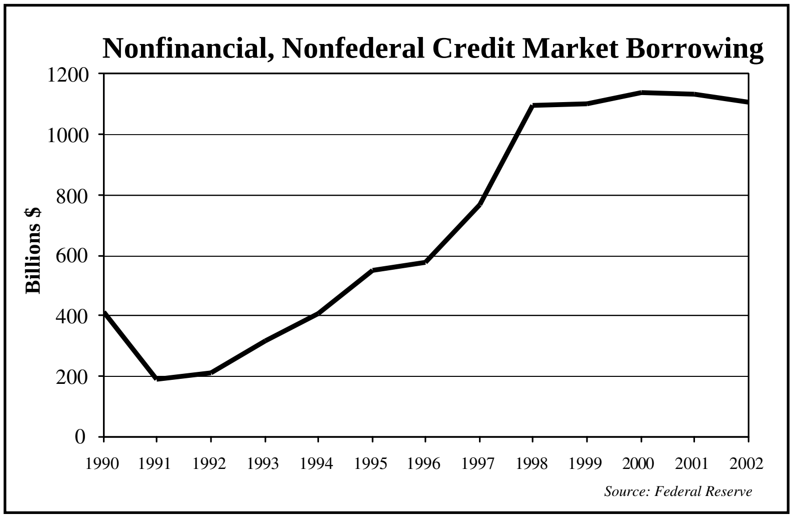
In those three busiest M&A years, deals in the United States totaled nearly $4 trillion — more than in the preceding 30 years combined. By now, it is widely recognized that most of them were blatant failures both for the companies and the shareholders. In general, the trumpeted synergy effects, for which the acquirers paid premiums of 30–40% and higher above the seller's market price shortly before the deal, grossly failed to materialize.

These three years were America's and the world's greatest stock market boom, during which the market value of U.S. shares, measured by the Wilshire index, soared by $4 trillion, or 48%. Before-tax profits of nonfinancial corporate businesses, however, fell at the same time from $496.1 billion to $437.9 billion, or 11.7%, and after-tax profits from $337.7 billion to $265.5 billion, or 21.4%. Most unusually, profits began to fall at the height of the boom.

THE PROFIT CARNAGE HAS MANY CAUSES

The U.S. economy's stellar growth performance lasted until 2000. Since 1997, it had steadily exceeded an annual rate of 4%. For American consensus economists, this rate is the main measure of economic strength and health. Due to this extremely narrow view, they failed to notice that the splendor of growth in the aggregate was disguising a most horrible pattern and structure of economic growth.

For over two years we have read that the U.S. economy's healthy recovery and the next bull run of the stock market are around the corner. Policymakers from Mr. Greenspan down have been counseling patience: *Let the healing process run its course.* Yes, but where is the healing process? In the profits? In savings? In net investment? In the trade deficit? We see no healing.



In contrast to regular past experience, however, this demand explosion didn't show in higher inflation rates. For the bullish consensus, this was another emblem of the U.S. economy's superior efficiency. What really happened was that the domestic demand excess largely spilled over into a soaring import surplus because worldwide many producers had idle capacity to meet it.

As to inflation, it needs a distinction between cause and effects. There is always one cause: excessive money and credit creation fueling demand growth in excess of available domestic supply. Measured by the exploding money and credit figures, America had its most excessive demand creation of all times during these years.

But as to the effects, excess demand may always express itself in two different ways — in higher domestic inflation rates or in a rising import surplus. If there was efficiency involved in this case, it was clearly on the part of the foreign producers.

In essence, the following table is an X-ray of the U.S. economy's most important inner organs of growth, how they developed from 1995 to 2002. It strikes the eye that all these aggregates show a sharp break in and after 1998. The first thing to see is its obvious key cause: a sudden sharp spurt of credit and debt growth, from $588 billion in 1996 to $781 billion in 1997, and to $1,095 billion in 1998. The other most drastic change occurred in the U.S. external current account. More than doubling from 1997 to 1998, it went on an

Key Economic and Financial Aggregates (billions $)

	1995	1996	1997	1998	1999	2000	2001	2002
1. REAL GDP*	2.7	3.6	4.4	4.3	4.1	3.8	0.3	2.4
2. AFTER-TAX PROFITS	285.4	310.1	337.7	305.8	293.2	265.6	205.3	197.0
3. DIVIDENDS	179.3	201.9	218.1	242.2	239.2	259.6	278.5	279.6
4. RETAINED PROFITS**	106.0	108.2	119.6	63.6	54.0	5.0	-73.2	- 82.6
5. NET INVESTMENT	203.1	243.1	299.7	365.5	378.3	407.3	268.1	
6. INTEREST BILL***	48.9	42.6	44.9	56.2	66.8	75.4	81.4	
7. DEPRECIATIONS	621.9	656.3	699.7	744.8	795.2	858.5	933.4	
8. PERSONAL SAVING	302.4	272.1	252.9	301.5	174.0	201.5	169.7	201.0
9. DEBT GROWTH****	696.4	724.2	789.9	1,046.2	1,031.6	840.9	1,125.9	1,363.7
10. CURRENT ACCOUNT	106.8	117.8	128.4	263.9	292.8	410.3	393.4	503.4
11. CONSUMER PRICES*	2.8	3.0	2.3	1.6	2.2	3.4	2.8	1.6

**growth in percent **business saving ***manufacturing ****nonfinancial*

unprecedented steep rise that still continues.

The table shows all the aggregates that significantly influence economic growth and in particular business profits and fixed investment.

Looking at this table, we see only continuous deterioration across the board right into 2002. Nor has there been any improvement in the latest monthly or quarterly data. A relapse in capital spending following a fractional increase in fourth quarter 2002 is especially disconcerting as is ongoing sluggishness in consumer demand. Above all, nothing in this table suggests the possibility of a significant rise in business profits. Just the opposite appears probable.

On the micro level, depreciation expenses remain in a sharp rise, while record-high corporate debts are keeping interest expenses at a record-high level. On the macro level, declining net investments and the rising trade deficit continue to depress business revenue.

The obvious crucial cause of the U.S. economy's protracted sluggishness is a capital spending crisis. That fact is no longer in dispute. But as to its cause and its cure, we note very muddled thinking.

In his already mentioned speech concerning the weakness in business investment, Mr. Bernanke elaborated on this question, too. His remarks can be taken as American consensus view:

> *Most economists agree that a strong and well-balanced recovery will require a greater contribution from the business sector, in the form of increased capital investment and hiring… Investment spending by firms depends primarily on two factors: first, the projected growth in business output, as determined by final demand, and second, the cost of acquiring and using capital goods, the so-called user cost of capital.*
>
> *Higher projected output growth naturally leads firms to expand their capacity to produce by investing in new capital goods. This relationship between the growth of demand and the level of investment spending, dubbed the accelerator effect, is a venerable and empirically well-supported relationship in economics.*

AMERICA'S CONSUMPTION BIAS

At the bottom, he seems to say that the protracted investment weakness in the United States comes mainly from insufficient final demand. The implicit, logical conclusion is the need for more demand creation, essentially through more monetary and fiscal stimulus. Well, that is what the Federal Reserve and the government have been doing with outstanding abundance, however with most unsatisfactory economic effects.

America, clearly, has completely unfettered credit and capital markets, and in the last two years, the economy also got the most prodigious monetary and fiscal stimulus. Comparing the resulting, virtual credit and debt deluge with its miserable economic effects, there is manifestly a radical disconnect between financial system and economy.

For sure, American producers are facing insufficient demand. Yet we hasten to add that all this talk of deflation and lack of demand in America is ludicrous in the case of a country that is running a current-account deficit of now more than $500 billion, or over 5% of GDP.

Such a deficit reflects, by definition, an equal excess of domestic spending over domestic current output and income. However big America's recorded capital overhang may be, the record-high and still-rising trade deficit indicates that the true lack in the U.S. economy is not credit and effective demand, but competitive capacities.

What the reported capacity overhang probably reflects is overwhelmingly past malinvestments. Considering the huge amounts spent by American firms and consumers on foreign goods, America's growth problem is definitely not on the economy's demand side, but on its supply side. And as to credit creation, there is obviously far too much of it, not too little, resulting in a tremendous imbalance between the huge amounts of credit going

into consumption and the tiny amount going into capital formation.

America has always been a high-consumption, low-investment and low-savings economy. But this time, this pattern went into unprecedented imbalance. This bias towards consumption is not by accident. It is a traditional, widespread view in America that consumption is a far more important element in the economy than investment.

Typically, the policies of all presidents were aimed primarily at stimulating consumption. Even the logic behind the Bush government's tax cut for dividends is that it will stimulate consumption through wealth effects in the stock market. Another result of this bias has been a credit system that is overwhelmingly geared toward consumer credit.

This notion that consumption governs business investment and economic growth has always been confined to the world of English-speaking economists, primarily American economists. And by the way, it was not Keynes but some obscure American economists, Foster and Catching, who caused a sensation with this idea in the 1920s. At the time American producers invented and developed consumer installment credit. Construction and business fixed investment stopped growing in 1926. During the following three years, consumption alone accounted for total GDP growth. To us, the parallels in this respect between then and today are ominous.

In essence, it is a growth model that builds completely on consumer credit because consumer incomes — normally the main source of consumer spending — essentially derive from what the consumer earns in the production process.

It is our long-held view that this obsession of American policymakers and economists with consumer spending misleads them to pay far too little attention to business investment and the influences that spur or suppress it. The apparent, conclusive cause of the U.S. economy's protracted sluggishness is the slump in profits and capital spending, and we see nothing that suggests any improvement.

What induces businesses to invest and produce is ultimately one single thing, and that is the prospect of profit. Profits and profit expectations are paramount for investment spending and economic growth. *"We live in a society organised in such a way that the activity of production depends on the individual business man hoping for a reasonable profit… The margin which he requires as his necessary incentive to produce may be a very small proportion of the total value of the product. But take this away from him and the whole process stops. This, unluckily, is just what has happened,"* wrote economist John Maynard Keynes in 1931.

And, unluckily, this is just what has happened this time all around the world. In the capitalistic economy, profits lie at the heart of economic growth. In the United States and many other countries, profits as a percentage of GDP have collapsed to their lowest level in the whole postwar period. Yet it strikes us how little attention this disastrous fact has been finding in the public discussion.

THE DOLLAR CRISIS

Pondering the global economic outlook, we mull over one question more than over any other. That is the fate of the dollar and its implications for economies and financial markets around the world. Treasury Secretary John Snow recently discarded its decline so far as moderate. That is true when measured against a broad basket of U.S. trading partners. But who is moderating it? Extremely loose U.S. monetary and fiscal policies are, effectively, precipitating the dollar's fall. The lonely defenders with permanent, huge dollar purchases are the Asian central banks.

How deep can the dollar fall? In short, deeper than most people can imagine because, with a sluggish economy, American policymakers will never defend it, and with all its atrocious imbalances it will stay sluggish for years to come. For us, this raises two highly critical questions: first, how long will the Asian central banks continue their big dollar purchases if the dollar crisis stretches on and on? And second, what will happen to the U.S. bond bubble under these conditions?

Foreign gross holdings of dollar assets amounted at their latest count at end-2001 to more than $9.2 trillion at market value and to about $8.1 trillion at current costs. At the time, the United States was a net debtor to the rest of the world by about $2.3 trillion. With an ever-rising current-account deficit, this should now be approaching $3 trillion, or 30% of GDP.

Curiously, the dollar's fall has accelerated since America's Iraq victory, while U.S. stocks rallied, supposedly pricing in a postwar rebound. The fact is that downward pressure on the dollar comes massively from two sides.

The one is the still soaring trade deficit. In the fourth quarter of 2002, the current-account deficit hit an annualized $548 billion, a record 5.2% of GDP. That surpassed the previous record of 4.5% hit in late 2000. In 1987, the dollar collapsed in the face of a 3.4% external gap.

Over the past few years American policymakers and economists have diligently propagated the idea that America's huge and soaring current-deficit, far from being a serious problem, represents the positive emblem of economic strength that is inherently attracting more than enough foreign capital to finance it. Conversely, the euro and yen are weak because their economies are weak. We suspect that the belief of this relationship between economy and currency still sticks in many heads, holding the bear speculation against the dollar in check.

It is blatant nonsense. There are several major countries that have notoriously been running a surplus also in boom times. As a matter of fact, America did in the 1920s. The basic reason is always that savings exceed investment. During its bubble years, Japan's current account remained in a chronic, big surplus even with real GDP growth averaging 5% per year.

Japan's huge export surplus persisted despite sharply accelerating GDP growth for two main reasons. The one was a roaring investment boom in manufacturing plant and equipment and commercial building, thanks to which the growth of manufacturing capacity outpaced the growth of domestic demand. And the other reason was higher domestic savings that freed the resources for the investment boom. Japan's gross national savings rate (including depreciations) averaged 33% during the bubble years, comparing with presently less than 15% in the United States.

By comparison, it is clear that the horrendous U.S. trade deficit has its roots in the gross imbalance between consumption and capital investment. The earlier mentioned fact that the net stock of fixed assets in manufacturing has increased by an annual average of 2% since 1995, as against domestic demand growth of 5%, plainly exposes the U.S. economy's key problem. It is primarily a gross lack of supply, not lack of demand.

REFUSAL TO ADJUST

Recognizing this lack of supply, another troubling question immediately comes to mind. Most American economists seem to regard the dollar's sharp depreciation as part and parcel of the classic current-account adjustment process, as dollar weakness makes foreign products more expensive for the American consumer, while making American products cheaper for foreign buyers.

It is a new illusion. A currency devaluation by itself, however large, does next to nothing to correct a trade deficit. During 1985–88, the dollar fell steeply against the DM and yen. Yet the U.S. trade deficit continued to soar until 1987. On the other hand, although the DM doubled in value against the dollar, its current account surplus in dollar terms more than tripled from 1985 to 1989, rising from 2.6% to 4.6% of German GDP.

It used to be the standard view among economists that the correction of a trade deficit first needs demand restraint in the deficit country. In other words, price adjustment through the exchange rate is not enough. The fundamental cause of the monstrous U.S. trade deficit is that Americans spend vastly in excess of their current production and income.

It is a fatal mistake to believe that a currency devaluation is a substitute for the necessary domestic adjustment measures that governments in general, and present U.S. policymakers in particular, want to avoid.

Actually, both the government and Federal Reserve are desperate to increase domestic demand in the United States with their super-loose policies. Not caring about savings, the current-account deficit and the dollar, that is the one and only aim they pursue. There is not the slightest intention to defend the dollar. Besides, the danger of pricking the bond bubble prohibits any such thought.

The loaded question is whether a hard landing of the dollar may at some point cause a hard landing of the U.S. financial system. It seems most probable to us. True, it didn't happen in the 1980s. But there are two highly important differences between the two periods: first, past and present excesses in the U.S. economy, its financial

markets and in the trade balance vastly exceed those in the 1980s; second, this time the trade deficit's financing has been through the stock and bond market. In the 1980s, it occurred completely through foreign bank lending.

CAPITAL ACCOUNT VS: CURRENT ACCOUNT

What buoyed the dollar in the past several years were capital inflows that soared even faster than the current-account deficit. It was always clear that the dollar would plunge once the capital inflows fall behind the monstrous deficit. The obvious cause of the previous stampede of foreign capital was the euphoria about a new paradigm U.S. economy, offering investors unprecedented miracles of return.

Meanwhile, both the profit miracle and admired equity culture are in shambles. Of course, this drastically slowed the capital inflows. What is worse, the U.S. trade deficit keeps soaring. Its March numbers were up 33% from a year ago. To us, it was self-evident that this would pull the rug out from under the dollar and the stock market. Well, both have suffered a steep decline, yet as to, we still note rather more complacency than worries in the general sentiment about the U.S. economy. Stock market sentiment is just as bullish as it can get.

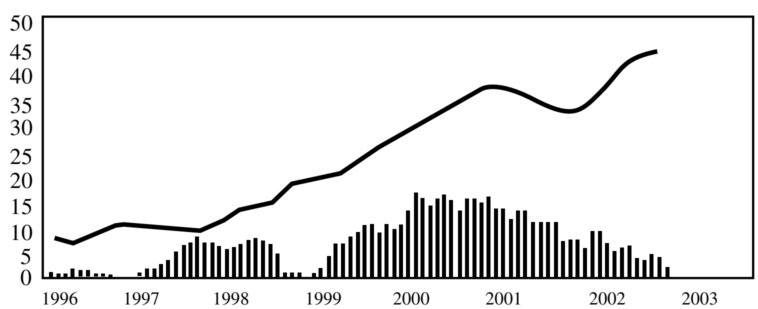
Foreign investors have bought a total of $588 billion worth of U.S. stocks since the beginning of 1995, when the big boom started. Manifestly, these purchases were a key driver both of the stock market's bull run and of the dollar's appreciation. Temporarily, foreign buying of stocks covered about 50% of the U.S. current-account deficit.

While the stock purchases have virtually ceased, foreign purchases of Treasury and agency bonds have soared. We presume, however, that this buying comes overwhelmingly from the heavily leveraged carry trade by American hedge funds, operating from abroad, but financed with cheap dollars. Therefore, this does not help the dollar.

Again, stabilizing the dollar requires capital inflows of sufficient size to cover the huge current-account deficit. For us, this is flatly impossible. In particular with the now-looming dollar risk, American stocks and bonds lack any attraction for foreign investors.

Since U.S. policymakers will do nothing to defend the dollar, it can only continue its plunge. We are at a loss to say what will stop it.

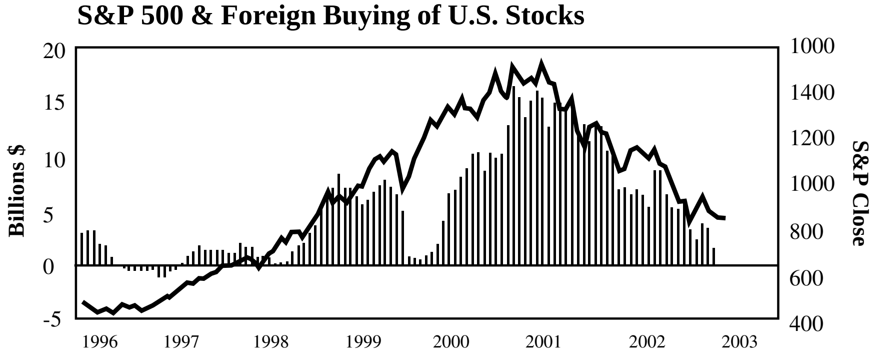
U.S. Current Account Deficit & Foreign Buying of U.S. Stocks



Source: Thompson Financial Datastream

The still rising U.S. trade deficit essentially implies that overall capital inflows have increased by the same amount. But here we have to distinguish between the euro zone and the rest of the world, mainly the Far East, where central banks desperately try to prevent, or at least slow, the appreciation of their currencies against the dollar by massive dollar purchasing

S&P 500 & Foreign Buying of U.S. Stocks



Source: Thompson Financial Datastream

The euro has been soaring against the dollar for two reasons: One is a dramatic reversal in the current account from a deficit into a growing surplus, and the other one is an even more dramatic reversal in the capital account. Capital outflows have virtually collapsed, while capital inflows

are increasing. Total outflows through direct investments and stock and bond purchases peaked in 2000 with more than €700 billion. In the fourth quarter of 2002, they were running at about €50 billion, or about €200 billion at annular rate.

WHAT ABOUT EUROPE?

Many American and English economists and journalists strike us with their outstanding ability to see no problems at home, but very big ones elsewhere. Lately, a great sensation is made of the fact that Germany and the euro zone are courting new economic stagnation.

Indisputably, that is true, and certainly there is no false optimism about the economic outlook, as in the United States. Yet there is false optimism — about the U.S. economy's recovery.

For many observers, the strong euro, by strangling exports, is now the final nail in the economy's coffin. Typically, it is also widely argued that its strength has nothing to do with European strength, but only with American weakness.

Of course, a strongly rising currency squeezes the profits of the export industries, but exports to the United States are marginal for the euro zone. The single biggest exporter in the area is Germany, with total exports accounting for 31% of GDP, of which 10% is going to the United States. Besides, it is easy for corporations to protect their profits by hedging against the dollar. With U.S. interest rates so low, it is even profitable. But false optimism about the U.S. economy and the dollar has prevented most enterprises from doing that.

Actually, German exports to the United States have by no means been booming during the strong dollar years. They fell sharply from 1998 to 1999, followed by a moderate recovery. For certain branches and enterprises, these exports are without question of great importance, but by no means for the economy as a whole.

It is our long-held view that the effects of exchange rate changes on trade flows are in general grossly overestimated, while the most important influence is completely ignored — namely, the terms of trade effects, in other words, the effects of the changes in import prices on domestic purchasing power. The fact is, the rising dollar, through boosting the euro zone's import prices, caused a massive destruction of purchasing power

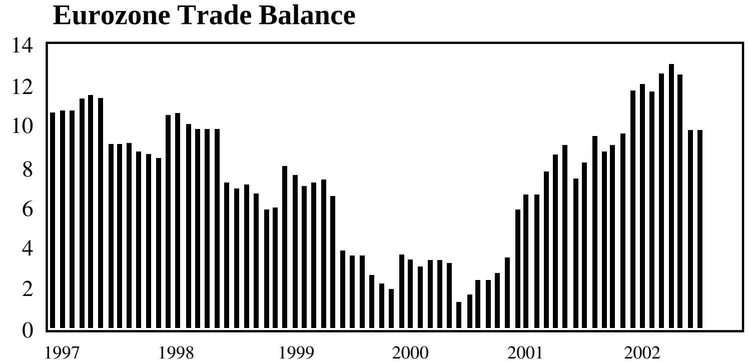
Finally, a few remarks about the two central banks that are at the center of world attention — the European Central Bank and the Federal Reserve. Accusing it of a lack of action, the ECB is under permanent, partly vitriolic, attack in the American and British press, while Mr. Greenspan is widely praised for his activism. As against this, complaints about the ECB in directly affected Europe are more than muted.

It is our view that Mr. Greenspan, after all, will go into the history books as the Fed chief who devastated the U.S. economy. What he keeps saying suggests to us that he understands nothing of what is happening in the markets and in the economy. He completely disregards all excesses and ignores escalating financial and economic imbalances and distortions.

The American economy is sick to the bone from protracted unprecedented household debt growth, an exploding government deficit, unparalleled credit market speculation, asset bubbles, endemic trade deficits, a plunging currency, negative national savings and poor corporate profitability.

Europe's economy, too, is very sick. Basic to its weakness is a chronic investment-savings

Eurozone Trade Balance



Source: Thompson Financial Datastream

gap. Germany, specifically, is also struggling with economic and financial woes from unification. Lack of global competitiveness is definitely not its problem. It is the country with the highest export ratio, accounting for 31% of GDP, as against 10% for the United States and 9% for Japan. Its export surplus equals 6% of GDP.

But why are Europeans so lethargic about monetary and fiscal policy? We think the main reason simply is that they do not believe in their usefulness. If businesses do not invest at these low levels of interest rates, they will not do so at still cheaper rates. See Japan, see America.

CONCLUSIONS:

For the U.S. post-bubble economy it is inflate or die, postpone the day of reckoning at all costs and hope for a miracle. Fighting the painful consequences of the bursting stock market bubble with looser and looser money, the Greenspan Fed has created three new bubbles — a housing bubble, a mortgage refinancing bubble and a bond market bubble with unprecedented leverage.

Endless liquidity is available for speculation of unprecedented recklessness. Debt spreads have virtually collapsed as speculators are turning to junk for higher interest rates. The riskier the bond, the sharper it has recovered. With its well-founded fear of economic vulnerability, the Fed has set the stage for one final period of parabolic credit excess.

The American public is closing its eyes to the fact that this greatest credit bubble of all times has hardly had any visible effects on the economy. Yet there remains an unbelievable optimism that the loose monetary and fiscal policies will in due time stimulate a strong recovery. Hard evidence that the U.S. economy is heading back into recession will, instead, prick all these bubbles.

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